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Securitisation – the silver bullet for the non-performing loan market?

Introduction

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In an earlier Alert, *Non-Performing Loans and Securitisation in Europe*, dated April 7, 2016, we examined the basic structure of an NPL securitisation and the importance of the servicing function in the operational success of such a transaction. As the global financial crisis has left many countries with significant levels of NPLs, particularly in south and eastern Europe, techniques to successfully reduce the level of NPLs are becoming increasingly important. This is especially so given that NPLs tie up bank capital that could otherwise be used to increase lending, and so reduce the supply of credit to the real economy as well as impeding the financial recovery of the banks.

Since our earlier Alert, there have been further regulatory developments to promote the sale of NPLs and the development of a market for NPL securitisations, particularly in Italy with the creation of a €5 billion bail-out fund, *Atlante*, and, prior to that, the Italian state guarantee of senior notes issued by securitisation vehicles backed by NPLs, supplemented more recently by reforms to enhance debt enforcement and insolvency regimes.

This Alert examines some of the regulatory, legal and market-based challenges of deleveraging NPLs and how securitisation as a financing technique might be used effectively to address this.

Regulatory considerations applicable to NPLs

1. (Avoiding) loss recognition

What is a non-performing loan? This question was an issue interpreted differently across and within different European jurisdictions, but in 2013, the European Banking Authority ("EBA") issued a recommendation to the competent authorities in the EU to run asset quality reviews for their financial institutions, based on newly harmonised definitions of NPLs.

Pursuant to those EBA definitions, an NPL is defined as an exposure in respect of which the debtor has not made scheduled payments for a minimum period of time (90 days) or is unlikely to pay without collateral realisation, in each case even if it is not recognised as defaulted or impaired in the bank's books. An exposure can be non-performing on an individual or debtor basis, but all exposures to a debtor are deemed non-performing when on-balance sheet exposures that are more than 90 days past-due are more than 20% of the aggregate of on-balance sheet exposures to the relevant debtor.

Whilst a common declaration of what constitutes NPLs in each jurisdiction is helpful, and since its introduction has added over Euro 50 billion of additional NPLs to the European pool, it is of course not the full story. Changes to definitions have not, in and of themselves, brought about any change in accounting or regulatory treatments, which often differ between countries and which may weaken the incentives financial institutions have to resolve NPLs, for just some of the following reasons:

a. **Impact on regulatory capital requirements:** though the largest EU financial institutions use IFRS accounting, the current incurred-loss approach to loan provisioning under IFRS is backward-looking and leaves much room for subjectivity, which may result in insufficient loan provisioning by a financial institution in respect of its NPLs, especially where there are other strategic reasons to avoid loss recognition such as the impact on capital adequacy ratios;

b. **IFRS 9:** IFRS 9 (which comes into force on 1 January 2018) requires lower values of NPLs to be recognised on the balance sheet of a financial institution as soon as it adopts a selling strategy (known as the "business model test"), so again, financial institutions are potentially dis-incentivised from adopting such a strategy;

c. **local accounting rules:** certain local regulators (for example in Spain, Hungary, Malta, Poland and Romania – which are jurisdictions that continue to harbour significant levels of NPLs) have additional accounting rules (including in respect of loan provisioning) that have a negative impact;

d. **write-offs:** whilst from the perspective of transparency and capital adequacy, writing off loans that a financial institution no longer expects to be repaid appears a positive matter, retaining NPLs but increasing the provisions made in respect of them also make financial institutions appear less risky and could therefore increase financial institutions' external credit ratings, thereby creating another reason why financial institutions could be dis-incentivised to deal promptly with NPLs; and

e. **lack of commonality:** as a general matter, the current lack of commonality across the EU in terms of the accounting or regulatory metrics used to estimate capital requirements, risk weighting and impairment levels could be seen as an impediment to a transparent and liquid NPL market.

2. Regulatory environment

In addition to the commercial drivers to avoid loss recognition, there have historically been regulatory hurdles to the deleveraging of NPLs using securitisation as a technique. Current regulation in this area seeks to impose high capital charges from the perspective of the financial institutions and insurers investing in such securitisations relative to other funding instruments of similar credit risk. The regulatory cost of securitisation of NPLs on the buy-side is therefore very high relative to the cost of holding the NPLs on balance sheet as originating bank or as direct purchaser of NPLs in a whole loan sale. Furthermore, the requirement for EU credit institutions to ensure that an eligible entity has "skin in the game" for the life of the transaction via the risk retention requirements in the Capital Requirements Regulation ("CRR") before investing in an NPL securitisation adds further complexity at a time when the European banking system is under pressure to deleverage its problem loans quickly and efficiently.

3. Risk retention

In terms of risk retention rules, the definition of a securitisation transaction for the purposes of the CRR is wide-ranging. It captures any transaction under which the credit risk associated with an underlying exposure is tranched, payments are dependent on the performance of the assets and where the risk of losses is throughout the life of the transaction. To consider this further, a typical structure for a NPL acquisition is as follows:

a. NPL portfolio is sold by a financial institution to a private equity fund (the "Fund") after the completion of a competitive bidding process;

b. the Fund acquires the portfolio via a newly incorporated vehicle (the "SPV"), which funds the acquisition by issuing/borrowing senior debt and subordinated debt (either of which could take the form of notes or loans) – the senior debt being in the form of funding from third-party financiers and the subordinated debt representing the "equity" interest of the Fund;

c. the subordinated debt is contractually subordinated to the senior debt; and

d. collections from the NPL portfolio (whether by way of collections from the underlying borrowers or from disposals of the NPLs and/or the underlying properties, pursuant to an enforcement or otherwise) are applied in repayment of the senior and subordinated finance parties pursuant to an agreed priority of payments.

It is clear that the above structure involves a pool of exposures being funded by debt that is tranched, with the debt being dependent on cashflows from the underlying NPLs, with any losses from the NPL portfolio being throughout the life of the loan and being borne first by the subordinated debt. On the face of it, therefore, this is a securitisation for the purposes of the CRR, which requires an EU credit institution investing in the transaction (e.g., by way of the senior funding) to ensure that an eligible entity undertakes to retain (at risk to itself) a minimum of 5% of the overall risk for the life of the transaction, in an eligible form (usually this is effected by a holding of the first loss piece, or a vertical slice of the overall portfolio risk).

In the context of a NPL transaction, however, it is not immediately obvious which entity is the eligible entity to retain the risk. The CRR states that this can be either the original lender of the underlying loans, the sponsor of the transaction or the originator of the underlying loans. Taking each of these in turn - the original lender of the underlying loans is the financial institution selling the NPLs, so this is not relevant. The “sponsor” of the transaction has to be a regulated credit institution or investment firm, which would not be satisfied in respect of the Fund itself. A regulated manager of the Fund may qualify but would not typically be capitalised to fund a risk retention. Finally, the definition of “originator” is split so that, as well as capturing the “real” originator (i.e., the entity involved in the original creation of the loans or the seller of those loans if already transferred), it also captures an entity that buys the assets “for its own account and subsequently securitises them”. While the SPV is not, strictly speaking, an originator, market practice has developed so that an entity like the entity providing the subordinated funding would be regarded as the originator, the analysis being that an “originator” includes an entity that purchases loans for the purpose of securitising them; the process of acquiring and securitising loans is often (and for good reasons) organised through special purpose vehicles; and the subordinated finance provider, whilst not purchasing the loans for the purposes of securitising them itself, can be said to be doing so through the SPV, an entity to which it provides the subordinated funding thus making it an originator.

We have seen varying approaches to documenting risk retention in the context of NPL securitisations. In our view, the analysis described above achieves substantive compliance with the risk retention requirement. However, for now, it should be recognised that there are other views.

Legal and market environment

One of the key factors in achieving a swift resolution of NPLs is the legal and judicial system within which the loans operate. The following obstacles (among others) should be considered:

a. **low average recovery due to the long duration and high cost of the legal process –** especially in jurisdictions with high NPL ratios. This can be due to various factors, including regimes which allow debtors to apply for postponement orders (which are usually granted), or high taxes that are applicable upon a sale of underlying properties. There is significant variation across EU legal systems on this;

b. **complexity of the insolvency law and proceedings –** it is not uncommon for the relevant proceedings to last longer than three years and in some jurisdictions over five years. The pricing differential between the on-balance sheet book value and the market value becomes all the more pronounced when lengthy recovery procedures are factored in (although countries like Italy are aware of this issue, and in Italy recent legislation has been introduced to seek to speed up the time to dispose and reduce the cost of doing so); and

c. **lack of a securitisation law –** not all European jurisdictions have securitisation rules enshrined in civil law. Those without such rules suffer from reduced marketability.

In addition to issues referred to above around loss recognition, there are other more market-based obstacles to NPL resolution, including reputational issues and lack of transparency borne out of a difficulty in obtaining standardised and reliable real estate valuations.

Conclusion

Regulators have taken significant steps to strengthen the EU banking sector since the global financial crisis, including in respect of NPLs. However, and as we have noted above, there remains some work to be done in terms of harmonising the supervisory guidance in respect of the deleveraging of NPLs. There is, for example, as we have seen, a considerable amount of uncertainty and divergence in approach – including in terms of whether outright disposals of NPL portfolios funded by senior and subordinated debt should be caught by the retention requirements of the CRR. In light of the need to resolve the considerable NPL overhang in Europe, a balance needs to be struck between removing the hindrances to a fully functioning portfolio acquisition finance market (including by way of "securitisation" as described above) whilst fostering a stable regulatory environment.